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Taking back the controls: modernising the financial framework for housing investment

About this paper

This paper explores the framework of fiscal rules, accounting practices, funding allocations and spending control processes that the UK government deploys to manage public investment. It does not discuss the overall quantum of public spending, how such money should be raised, nor what it should be spent on, but rather the systems by which these decisions are made and then put into practice. These issues sound, and often are, technocratic and even arcane. But in the context of a modern state deploying trillions of pounds a year even small adjustments to the rules governing the flow of money can have critical consequences for the economy and public services, and as such the issues explored here are in fact deeply political. As one academic study puts it, 'public finance is politics hidden in accounting columns.'

This paper, by consultants Toby Lloyd and Rose Grayston at On Place, is the result of consultation with academics, experts, social landlords and practitioners in local government, planning and development. We do not claim expertise in all of the issues discussed here, but seek to identify themes and questions that those in government or opposition might find helpful, and to make recommendations for change that could support more effective public investment. We focus particularly on explaining the implications of the fiscal regime for housing investment, but many of the issues raised apply equally to infrastructure and other sites of public investment. A summary follows of the major themes covered and our recommended actions for the next government to take to modernise the financial framework for housing investment.

Summary and recommendations

The UK governmental system is famously centralised in Whitehall and Westminster, and dominated by the powerful Treasury. This fosters a culture of central control that drives underinvestment, as the Treasury seeks to maintain its grip on overall public spending through a complex series of mechanisms over the raising and spending of money throughout the public sector – and particularly by local authorities, who are subject to multiple layers of control and almost entirely dependent on Whitehall for funds.

Controls on overall borrowing: fiscal rules and accounting conventions (p.6)

Criticism of fiscal rules has focused on their role in driving the UK's well-documented pattern of underinvestment, which is attributed to the short term nature of debt targets; the failure to distinguish between investment and current spending; and the metrics chosen for measuring the debt.

Recommendation 1: the simplest way to address the underinvestment bias of the fiscal rules regime would be to replace the Net Debt Rule with a version of the Golden Rule, making it easier for the government to borrow for investment purposes than for current spending. (p.9)

Recommendation 2: that any future debt-targeting fiscal rules adopted by the UK government should use the accepted international GGGD measure as the definition of public debt, which excludes public corporations (and therefore council borrowing for housing held within their Housing Revenue Accounts). (p.11)

Recommendation 3: the next government should continue the progress towards Net Worth Accounting, increase its use in assessing the public finances, and include a Net Worth Objective in its fiscal rules. (p.13)

Controls on housing providers' finances (p.14)

Since public sector capital investment is largely provided through borrowing and delivered by local authorities, tight controls on council borrowing via the Public Works Loan Board and Housing Revenue Account systems directly constrain the ability of the UK public sector to invest, particularly in capital-intensive assets like infrastructure and housing.

Recommendation 4: the next government should commit itself to not reimposing borrowing caps, redistribution mechanisms or any other system of complex HRA financial restructuring, relying instead on the principles of the Prudential Code to ensure councils' borrowing remains prudent. (p.17)

Recommendation 5: the next government should allow local authorities to pay down expensive older debt without incurring penalties. Local authorities should then be able to take out new PWLB loans to support housing and infrastructure projects at new, lower rates, within the limits of the Prudential Code, or to reduce their total levels of debt and debt service costs. (p.18)

Recommendation 6: the next government should revert to the previous position of allowing council borrowing via the PWLB at very small margins above base rates, and confirm a commitment to maintain rate stability for the long term. (p.19)

Recommendation 7: the government should commit to keeping all the rules on HRA and PWLB as simple and stable as possible, to improve confidence, reduce skills barriers and enable more councils to open HRAs. Any changes should be made following well trailed and transparent reviews involving all relevant stakeholders, not via overnight announcements. (p.19)

The UK's domestic subsidy control legislation is constraining investment in social and affordable housing more rightly than international agreements require.

Recommendation 8: the government should clarify how local authorities can on-lend capital (including from the Public Works Loan Board) to not-for-profit civic bodies without breaching Subsidy Control rules, ensuring housing projects benefit fully from SPEI Assistance provisions. If necessary, the Subsidy Control Act should be amended to remove administrative and practical constraints to PWLB on-lending. The government should in all circumstances avoid setting its domestic subsidy control legislation with respect to social and affordable housing more tightly than international agreements require. (p.20)

Central government has also made frequent, short-term and often badly-designed changes to its systems for setting rents, benefits, capital grant rates, the Right to Buy regime and other crucial policy inputs for social and affordable housing, undermining social landlords of all types by destabilising their operating environment and increasing their costs.

Recommendation 9: government should seek to increase borrower and lender confidence alike by committing to longer term stability and predictability of the rent, welfare and grant regimes. Specifically, government should: (p.25)

- ***Increase the duration of Affordable Homes Programmes from five years to ten and commit to additional funding to boost the programme on a per unit and per annum basis.***
- ***Give councils and smaller housing associations the same long-term grant packages as the larger associations deemed 'strategic partners'.***
- ***Peg capital grant rates in the Affordable Homes Programme, Social Housing Decarbonisation Fund and other pots to an inflation index (ideally Building Cost Inflation).***

- ***Commit to longer-term rent settlements that are more resilient to economic change. Above all, rent settlements must last for their intended period, i.e. a 10-year rent settlement should last for 10 years. If straying from a long-term settlement in one year becomes truly unavoidable, rent policy should be adjusted in subsequent years to ensure social landlords' revenues are stable and predictable across the period of the settlement.***
- ***Commit to uprating benefits payment levels every year in line with the Consumer Prices Index.***
- ***Allow councils to keep 100% of their Right to Buy receipts permanently, without restrictions on how they can deploy them within their HRAs, and give them greater freedom to adjust Right to Buy eligibility and discounts in their areas.***

Relaxing Treasury controls on the PWLB and HRA systems means relying on the Prudential Code to prevent irresponsible borrowing by councils. Governance arrangements for local authority landlords should be reformed to improve accountability and transparency without relying on self-defeating Treasury control.

Recommendation 10: the next government should seek to introduce a new governance framework for council housing that would give tenants and residents a greater role in oversight, and ensure professional long term management of HRA assets. (p.26)

Controls on spending (p.26)

Central government tightly restricts the ability of local councils and housing associations to raise money for investment, and also limits councils' fiscal autonomy to raise money from taxes, keeping social landlords dependent on grants from central government. Here again, a raft of complex, opaque and constantly shifting control mechanisms slows down, complicates and blocks spending even once funds have been allocated.

Recommendation 11: replace irregular Spending Reviews with a longer term strategy matching departmental allocations and delivery plans to a limited number of clearly expressed government priorities. (p.26)

Recommendation 12: the government should replace short term, competitive pots for narrowly defined programmes with longer term, needs-based funding formulas that will give communities across the country the confidence and capacity to embark on bold, joined-up investment plans. (p.29)

Recommendation 13: to ensure public money is properly spent, councils and delivery agencies should be subject to proper audit and scrutiny of their spending of the funds allocated to them, reducing reliance on competitive bidding, project appraisals and clawbacks. (p.29)

The conditions attached to government funding – often with the intention of ensuring good value for public money – effectively exclude some communities from the funding they need to deliver on policy objectives. One particularly troubling example of this for housing investment is the Treasury's insistence that housing projects funded through the Affordable Homes Programme 2021-2026 must deliver 'net additionality', even in places where market conditions make this impossible to achieve.

Recommendation 14: the next government should in all cases avoid placing unnecessary conditions on local delivery bodies' access to funding, and should assess the spatial and other equalities impacts of any proposed conditions on access to funding when designing funding prospectuses. (p.30)

Recommendation 15: the next government should increase the flexibility of the Affordable Homes Programme and other Homes England funds, ensuring that capital grant can be spent on acquiring, retrofitting and refurbishing existing housing stock in places where 'net additionality' rules are not appropriate because of lower market demand. (p.31)

Treasury's Green Book appraisal methodology is often blamed for blocking public investment in housing and placemaking and for skewing it away from deprived places and towards the places where housing demand is highest. More research into social value and wellbeing measures is needed to fully capture the holistic impact of investment decisions on people's quality of life in central government spending decisions.

Recommendation 16: the next government should look beyond narrow metrics of value like BCRs to include the dynamic economics of placemaking and the wider impacts of social infrastructure in financial appraisal systems. Specifically, the next government should support and encourage the development of robust social value reporting frameworks to enable more rigorous monitoring and evaluation of spending and policy interventions in housing and placemaking. (p.32)

Since 2012, affordable housing delivery in London has benefited significantly from the devolution of housing funds and policy to the Mayor of London through 5-year settlements with central government. Eleven years on, it is time for other cities and other places to gain more control over the levers for delivering new homes.

Recommendation 17: the next government should continue and accelerate the welcome change in grant funding rules towards greater devolution and area-based criteria, rather than national financial metrics. (p.33)

Introduction

A culture of centralised control

The fiscal rules UK governments have used since 1997 have been intended to ensure fiscal discipline, with the aim of endowing future generations with assets and income in excess of debt and tax obligations; in other words, fiscal rules are supposed to provide an effective balance to the strong democratic incentive for politicians to borrow to spend more in the short-term to win votes today, leaving future generations to deal with the consequences. Headline fiscal rules are thus an explicitly political expression of financial rectitude that supplement long-standing rules and conventions governing the raising, spending and accounting of public money. As this paper discusses, UK governments' attempts to satisfy their own fiscal rules and financial conventions have severely restricted investment in housing, transport and other urgently needed infrastructure. This under-investment is a key driver of the UK's housing crisis, of spatial inequality and of the misery of poverty still experienced by millions of households.

The picture across the UK is complicated by devolution, as approaches to some aspects of policy have diverged between the four nations, and increasingly also between different Combined Authorities in England. Yet the UK Treasury's mechanisms for controlling the spending and policy decisions of subnational bodies of all kinds remain extraordinarily strong by international standards, and many of the crucial policy and funding inputs - not least the benefits system - are still decided in Westminster and Whitehall. This paper focuses on evidence from England due to better data availability here, although we note where the devolved nations have made different policy choices to the UK government, and some areas where Treasury control has continued to constrain devolved decision-making. In the final section of this paper, we also note the potential for further regional devolution within England to support a shift away from the culture of central control.

Entrenching underinvestment through fiscal rules

The UK's underinvestment problems are not the necessary consequence of tough choices needed to maintain public spending at sustainable levels. They are a consequence of political decisions driven by a combination of ideological preferences and institutional power hoarding, which are then reinforced by poor understanding among politicians and commentators of the technical issues. The UK government's choice of fiscal rules encourages fiscal decision-making that can seem positively perverse at times, as it can undermine the achievement of the government's own policy objectives and the efficacy of public services. The political priority given to fiscal rules also entrenches a culture of control and underinvestment that pervades the whole of government, as the Treasury seeks to maintain its grip on overall public spending through a complex series of control mechanisms over the raising and spending of money throughout the public sector – and particularly by local authorities, who are subject to multiple layers of control and almost entirely dependent on Whitehall for funds.

Ironically this under-investment bias ultimately weakens the UK's economic growth, and hence the strength of the public finances, the protection of which was the reason for fiscal control in the first place. As the Resolution Foundation's Economy 2030 Inquiry puts it, 'this habit of cutting public investment persists despite widespread recognition that doing so provides an additional headwind to already weak growth. Cross-country analysis suggests that an unanticipated 1 percentage point fall in the public-investment-to-GDP ratio reduces GDP by around 1.5% in five years' time.'

The illusion of good policy

A further irony is that, despite a complex web of Treasury rules designed to reign in local authority borrowing, total outstanding local authority debt is at historic highs. While Treasury control has succeeded in blocking many prudent local authorities from building affordable homes and infrastructure to respond to local need and support local growth, that same Treasury control has failed to stop some authorities from making risky investments in commercial property, or to prevent a growing number of local authorities - including Croydon, Thurrock and Slough - from effectively declaring bankruptcy in recent years. In June 2023, Woking Borough Council became the latest local authority to do so by issuing 114 notice, with an unprecedented budget deficit of £1.2 billion. The proportion of annual local authority spending dedicated to servicing interest payments has grown almost everywhere, and in some cases local authorities are now spending more on servicing existing debt than they are on delivering local services. Finally, chronic under-investment in housing, transport and other urgently-needed infrastructure is increasing demand for health, welfare and other public services, piling yet further pressure onto the public finances.

If the UK's current system for assessing the public finances and making public spending decisions is intended to achieve fiscal discipline and to leave future generations of voters with a strong national balance sheet, it has failed miserably; but it has failed slowly and with minimal accountability. This situation has perpetuated the illusion of good policy, tightly controlled by a disciplined and disciplining Treasury. In fact, as this paper will explain, central control continues to frustrate good funding decisions capable of delivering policy objectives. Counter-productive Treasury control distorts decision-making at every level of government, but today many of the greatest perversities are found at the local government level. This has much to do with central government's decision from 2010 to concentrate austerity measures on local government, cutting local services fastest and hardest - though it also reflects deeply-rooted trends going back decades.

Consequences for delivering housing and infrastructure

A recent report from the Home Builders Federation, *Planning for Economic and Social Failure*, suggests housebuilding in England is set to fall to 120,000 a year – the lowest level since the second world war. Declining rates of housebuilding are also putting hundreds of thousands of jobs at risk, with major implications for the country's economic growth. These new risks come on the back of decades of relatively low investment in new housebuilding and infrastructure, which have left the UK's infrastructure stock as a percentage of GDP lagging behind the rate in other OECD countries.

In theory, these problems could be eased by government support for more countercyclical housing supply: i.e. building more social rent and other affordable tenures for which demand is virtually unlimited across the country to support overall housebuilding numbers and maintain capacity while market demand is weak. Unfortunately, social landlords' capacity to deliver new affordable homes is shrinking under the strain of reduced grant rates, ongoing policy change and uncertainty, rising finance and construction costs, and the urgent need to address serious health, safety and decency risks in existing homes - as well as decarbonising those homes, with this last mission alone estimated to cost upwards of £104bn.

Higher interest rates in the capital markets have sharply limited housing associations' bond market activity this year, with some associations now struggling to access the affordable long-dated funding needed to build, manage and improve homes at scale. Meanwhile, many local authorities are still in the relatively early stages of scaling up their capacity to build homes, following decades in which they have been discouraged from taking a proactive role in housing provision. In England, 45% of local authorities do not have a Housing Revenue Account, placing a major practical constraint on their ability to deliver new homes at scale. The Chartered Institute for Housing reports that 44% of developing local authorities are now reducing their housing capital programmes in response to rising construction costs, reduced rent revenues and ongoing policy uncertainty.

The first part of this paper looks at the UK government's fiscal rules, the metrics in which they are expressed, and the national accounting systems that underlie them. The second section explores the specific ways in which central controls restrict local authorities' and housing associations' ability to raise finance for housing and infrastructure investment themselves, leaving them dependent on central government for funding.
The final section then discusses the further systems of control over the deployment of these resources.

1: Controls on overall borrowing: fiscal rules and accounting conventions

The fiscal rules regime

The UK has adopted no less than nine different fiscal regimes since 1997 – five of which have only lasted one year before being changed. Each regime has included a debt rule – that public debt should be falling each year, or should stay below a given level – designed to reassure the public and the financial markets that the government will not borrow irresponsibly. While there is a simple logic behind the aim of demonstrating fiscal rectitude, the political emphasis placed on current levels of public debt has been widely criticised for prioritising short run spending constraint over the longer-term strength of the national economy and prejudicing policy making against public investment. The highly centralised nature of the UK state (70% of public investment is central government controlled, far more than in similar countries) – means that fiscal constraint at the national level has a greater impact on total public investment than it might in a more devolved state. The prioritisation of debt rules also makes the choice of the *measure of debt* used of critical importance, and one on which there is no consensus.

The history of fiscal rules

Fiscal rules are restrictions on fiscal policy set by the government to constrain its own decisions on spending and taxes. For example, they might require that the deficit (the difference between annual government spending and revenues) stays below a certain level. Without fiscal rules, democratic politics may suffer from 'deficit bias': politicians face an incentive to borrow to spend more in the short-term, and leave future generations (and future politicians) to deal with the consequences. Governments therefore use fiscal rules as a way to commit themselves to responsible management of the public finances and so increase confidence among taxpayers and investors. Since 1990 almost all OECD countries have adopted some sort of fiscal rule (IMF, 2022), with the most common combination being a long-term objective for the stock of debt coupled with a medium-term target for borrowing (Resolution Foundation, 2019).

The first fiscal rules in the UK were the two adopted by the New Labour government in 1997. The Golden Rule stated that over the economic cycle, the government would borrow only to invest and not to fund current spending, while the sustainable investment rule stated that public sector net debt as a proportion of gross domestic product (GDP) would be held over the economic cycle at a stable and prudent level, averaging no more than 40% of GDP. These rules remained the same for 12 years, and were largely adhered to until the financial crisis dramatically disrupted the public finances. Since then no rule has survived more than four years, many have lasted only one year, and none has outlived the Chancellor that initiated it.

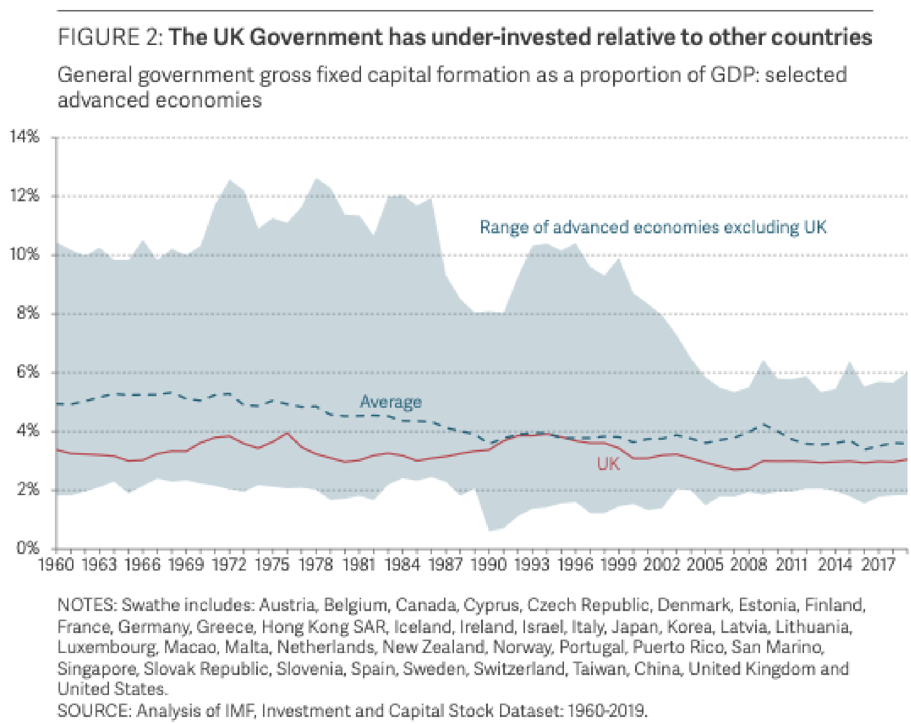
Dates active	Name of rule	Description of rule
1997–2009	Golden Rule	Revenues should cover day-to-day spending over the economic cycle
	Sustainable investment rule	Over the economic cycle, debt must average no more than 40% of GDP
2009–2010	Falling deficit	For each year from 2010/11 to 2015/16, the deficit (%GDP) should be lower than the year before
	Halving deficit	The deficit in 2013/14 must be no more than half the 2009/10 level (% GDP)
	Debt rule	Debt (% GDP) to be falling in 2015/16
2010–2014	Fiscal mandate	Cyclically-adjusted current budget should be in surplus at the end of a rolling five-year horizon
	Supplementary debt target	Debt (% GDP) to be falling in 2015/16
2014–2015	Fiscal mandate	Cyclically-adjusted current budget should be in surplus at the end of the third year of the rolling five-year forecast period
	Supplementary debt target	Debt (% GDP) to be falling in 2016/17
	Welfare cap	Spending on working-age benefits must not exceed a pre-defined limit
2015–2016	Fiscal mandate	Run a surplus in 2019/20 and in every subsequent year
	Supplementary debt target	Debt (% GDP) to be falling in each year
	Welfare cap	As above
2016–2019	Fiscal mandate	Reduce cyclically-adjusted deficit to below 2% of GDP by 2020/21
	Supplementary debt target	Debt (% GDP) to be falling in 2020/21
	Welfare cap	As above
	Fiscal objective	Eliminate the deficit 'as early as possible in the next parliament'
2019–2020	Current budget rule	Current budget should be in surplus by the third year of the rolling five-year forecast period
	Investment cap	Public Sector Net Investment should be below 3% on average over the five-year forecast period
	Debt interest spending rule	Debt interest spending must not exceed 6% of revenues

2021	Net debt rule	Debt (% GDP, excluding Bank of England) should be falling in third year of forecast period

Source: Institute for Government, Fiscal rules in the UK since 1997

Not all borrowing is equal

Criticism of fiscal rules has focused on their role in driving the UK's well-documented pattern of underinvestment, which is attributed to the short-term nature of debt targets; the failure to distinguish between investment and current spending; and the metrics chosen for measuring the debt. There is a little doubt that in terms of public capital investment, the UK is an international outlier (see chart below), and although the link between low levels of public investment and poor economic growth is less universally agreed on, it is increasingly clear that it has impacted on the provision of health services, public transport and affordable housing – all of which in turn have a material effect on the economy. As growth has remained persistently low for fifteen years there is a strong case for believing that increasing public investment must be a major part of the answer to the UK's 'productivity puzzle.'



Source: Felicia Odamtten & James Smith March, 'Cutting the cuts: How the public sector can play its part in ending the UK's low-investment rut' Resolution Foundation (2023)

It is also clear that the political priority given to debt targets, combined with the centrality of set piece annual Budgets in the UK political process, encourages short-termism in fiscal policy. In a complex, global economy most of the economic factors that determine total public borrowing are beyond the control of an individual government, at least within the short time horizons needed to hit an annual debt target. Many spending lines - like public sector pensions, benefit entitlements and international obligations - cannot readily be cut if tax take is lower and borrowing levels higher than expected in a given year. When its primary political targets are to meet a cash debt rule and keep tax rates down, the Treasury therefore prioritises retaining the flexibility to reduce other spending lines at short notice. In practice this usually means cutting public investment – even if this weakens economic growth over the longer-term.

It is not inevitable that fiscal rules will produce an anti-investment bias in this way: for example, while the Gordon Brown's sustainable investment rule is widely seen as having driven the New Labour government's enthusiasm for the Private Finance Initiative and other mechanisms designed to keep borrowing off the public books, the accompanying Golden Rule was explicitly designed to allow for borrowing to invest. This was achieved by distinguishing between borrowing to fund investment as opposed to current spending. Subsequent fiscal rules have failed to make this distinction, as each has focused on the total debt and/or deficit in cash terms, making the under-investment bias pervasive.

Recommendation 1: the simplest way to address the under-investment bias of the fiscal rules regime would be to replace the Net Debt Rule with a version of the Golden Rule, making it easier for the government to borrow for investment purposes than for current spending.

Accounting practices and measures of debt

The under-investment bias created by the centrality of debt rules in the fiscal targets regime is reinforced by the accounting practices of central government, which are very different from those of other economic actors in the way they treat assets, debts and other liabilities. There is both a broad and a narrow version of this problem: the narrow problem relates to the failure to distinguish between the different types of asset that borrowing may create, while the broader issue is about the overall practice of public finance accounting.

Not all investment is equal

The prioritisation of crude measures of public debt not only fails to distinguish between borrowing for current or investment spending – it also fails to distinguish between different types of investment. The orthodox treatment of government borrowing in purely cash terms is typically justified by the fact that investment in, say, new healthcare facilities, both requires immediate cash expenditure and creates an ongoing commitment of resources that must be paid for from government revenues. This is true no matter how beneficial the investment. For the purposes of financial credibility, the argument goes, it is therefore essential to treat all public borrowing in cash terms, as a claim on government revenues.

But this argument ignores the simple fact that some types of investment create their own revenue streams that can be used for repaying any debts incurred, whereas others do not. Even the Golden Rule's distinction between borrowing to invest and for current spending fails to distinguish in this way. Most forms of public investment do not generate predictable revenue streams: however much investment in new health facilities may improve NHS efficiency or benefit people's health and wellbeing, it will not create income streams to pay off the debt. Any broader economic effect it might have is uncertain, and even if it does support growth and therefore strengthens the public finances in the long-term these effects are hard to quantify, so the Treasury is understandably reluctant to treat them as secure.

But not all public investment is like this. Borrowing to build homes for rent is not the same as government borrowing to fund wages, benefits or tax cuts, or even other types of public investment. Investment in new public housing generates immediate jobs and growth, and it provides a secure, long-term income stream, along with ownership of a capital asset that may well grow in value over time. No other asset class has quite this profile: some others can generate income streams (such as toll-charging roads, tunnels and bridges), but these tend to depreciate over time. Housing investment is therefore uniquely able to cover its own financing costs – which after all is why Housing Revenue Accounts and New Town Development Corporations have both typically delivered profits to central government. Yet despite this unique characteristic, the United Kingdom persists in treating borrowing for investment in revenue-generating housing and infrastructure as equivalent to borrowing for other types of investment and current spending. This failure is then reflected in the accounting treatment of borrowing and debt, and hence the debt measure used for fiscal targeting, meaning it is subject to tight political control.

Use of PSND measure for fiscal targeting

The UK is unusual in including a very wide range of bodies as within the definition of 'public sector' used to measure public debt for the purposes of setting fiscal rules. All the fiscal rules set by UK governments in recent decades have included a debt rule using a version of the Public Sector Net Debt (PSND) definition of national debt. Not only is borrowing by central and local government included, but so too are the debts of what are termed 'public corporations' in the National Accounts (in accordance with international accounting practices). The public corporation category covers trading bodies like the BBC or the Driver and Vehicle Standards Agency – but it also includes Local Housing Companies set up by councils, ALMOs, and most significantly the entire Housing Revenue Accounts of stockholding local authorities, which are counted as a single public corporation for the purposes of the National Accounts. This means that these debts are treated as part of the overall debt figure targeted by the fiscal rules regime.

By contrast, the EU, IMF and most OECD countries use the General Government Gross Debt (GGGD) measure of public debt to define national debt for the purposes of fiscal targets and international comparisons. The GGGD measure includes both central and local government, but excludes public corporations, precisely because as arms-length trading bodies these agencies are generally responsible for servicing their own debts from their own revenues. The UK government's choice to include public corporations in the debt measure used for fiscal targeting is therefore an unnecessary distortion that prejudices political decision making against borrowing for investment in public housing and infrastructure.

The accounting treatment of housing association debts

Borrowing by local councils within their HRA to fund housebuilding all counts towards total PSND, under the public corporations column in the National Accounts, but housing associations are classified as private and therefore their debts do not register against fiscal targets at all. This is despite the fact that, to all intents and purposes, there is little difference between council-owned and association-owned social housing.

Between 2015 and 2017, housing associations were classified by the ONS as public bodies, due to the level of government control exerted over them when the government cut social rents in the budget of 2015. This brought £60bn of debt onto the public balance sheet overnight. The public accounts were also changed retrospectively, going back to 2008 when the legislation allowing the rent cut was passed. In 2017, following efforts by the government to 'relinquish just enough control', housing associations were reclassified by the ONS as private bodies, removing them entirely from the National Accounts again. While housing associations' borrowing and debts were included on the public balance sheet they were classified as public corporations, just as councils' HRAs are now.

While this 'fiscal illusion' had no impact on the ability of housing associations to service their debts or borrow, as it was purely an accounting change, it did influence government policy making, as it artificially undermined the government's ability to meet its own fiscal rule of having debt falling as a% of GDP. This episode demonstrates the distortionary effect that accounting practices can have on public policy if they are incorporated uncritically into political targets – or, as the OBR puts it, 'the degree to which statistical boundaries can drive regulatory policy decisions.'

The ONS continues to publish the General Government Gross Debt (GGGD) measure, as it was required to do when the UK was a member of the EU. The UK government therefore has the option to use this measure for its fiscal rules, bringing the UK into line with international practice across the OECD. Indeed, according to some of the experts consulted to inform this paper, doing so is necessary to fulfil the UK's commitments under the International Financial Reporting Standard, and it is a bone of contention with international partners that the UK has not already done so. Capital Economics, the Chartered Institute for Housing and Professor Janice Morphet of UCL have all supported this proposal. Using the GGGD measure for any future fiscal target would exclude councils' HRA borrowing from the target regime, making it more politically equivalent to housing association borrowing and reducing the Treasury's incentive to artificially restrict councils borrowing to build housing.

Recommendation 2: that any future debt-targeting fiscal rules adopted by the UK government should use the accepted international GGGD measure as the definition of public debt, excluding public corporations.

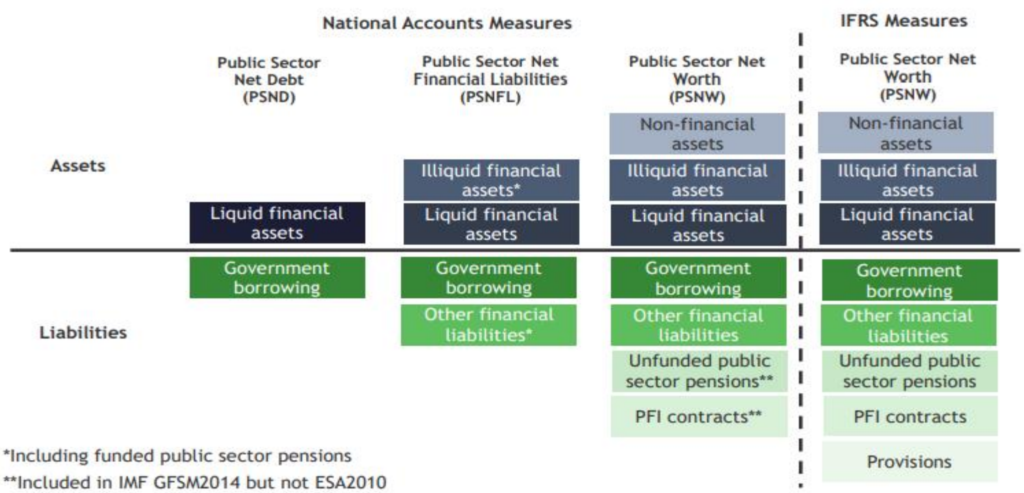
Accounting for assets as well as debts

The current fiscal rule targets the Public Sector Net Debt measure, excluding public sector banks (PSND ex). This is deemed a 'net' measure as it subtracts the amount of financial assets held by the government from the total amount of debt owed. But it does not net off the much larger value of the non-financial assets owned by the government - which excludes the value of public buildings, land and infrastructure - from the critical measure. There are valid reasons for this exclusion – primarily that most public assets cannot be readily liquidated and sold to pay off cash debts – but the effect is undeniably to reinforce the underinvestment bias from which the UK suffers. Put simply, the debts incurred to acquire public assets are counted in full, while any assets this borrowing might create are not, making borrowing to invest look like a worse proposition than a more holistic assessment would suggest. Martin Wolf of the FT puts this point bluntly: "It is the net worth of the government that should be the focus, not its debt. Focusing on just one side of the balance sheet, as the UK Treasury does, is ridiculous."

The ONS recognises this problem and has sought to address it by developing new measures of Public Sector Net Worth (PSNW) that take into account both the value of public assets and public liabilities (such as public sector pensions) that the PSND measures ignore. The OBR has also criticised the use of PSND for giving rise to '"fiscal illusions" – situations where accounting metrics do not reflect the true fiscal implications of a transaction – that can distort marginal fiscal decisions', and has started to make projections for PSNW into the future.

FIGURE 17: **Public sector net worth provides a summary of the whole public-sector balance sheet**

Coverage of alternative balance sheet metrics



SOURCE: RF analysis of HM Treasury, *'Managing Fiscal Risks'*, July 2018

From Resolution Foundation, Totally (net) worth it, 2019

New Zealand is the world leader in this area, having introduced a Net Worth Accounting system in 1989: some experts associate this shift with the steady improvement of New Zealand's fiscal position over recent decades, and to its relatively strong response to the financial shocks of the pandemic. However, this must be placed in context: New Zealand's switch to Net Worth was part of a comprehensive fiscal and accounting strategy that also included clear fiscal rules, monthly publication of public financial statements, and a Pre-Election Economic and Fiscal Update published 20-30 days before every General Election.

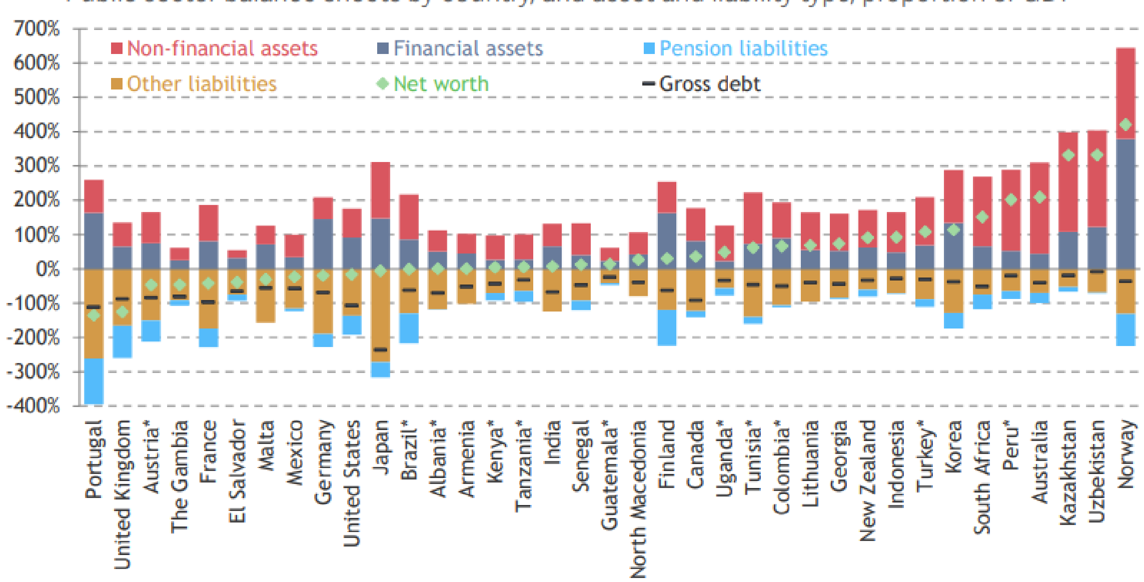
Moving towards Net Worth Accounting has been supported by commentators from across the political spectrum: Julian Jessop of the [Institute of Economic Affairs] states that 'fiscal conservatives are attracted by the hope that it would encourage governments to face up to longer-term liabilities that might otherwise be hidden "off-balance sheet", such as the future cost of some public sector pensions. It would also be harder for any government to get away with dodgy PFI-style deals'.

Other experts consulted for this research identify Net Worth Accounting as a [key to the creation of Public Wealth Funds] – mechanisms for enabling direct public investment in firms whose activities support public policy missions, and that 'combine arm's-length independence from day-to-day politics with active and competent commercial management, as well as a high level of transparency as if it were a listed holding company'. The Labour Party has also endorsed [moving towards a Net Worth system] of public accounts that can better account for public assets and liabilities.

As the most complete measure of fiscal sustainability, PSNW includes all assets and liabilities held by the government and all the entities it owns or controls. Under this definition of sustainability, the UK compares poorly with other countries:

FIGURE 4: **The UK has a relatively low level of public sector net worth**

Public sector balance sheets by country, and asset and liability type, proportion of GDP



NOTES: Missing data on gross debt position for The Gambia, El Salvador, Albania, Armenia, Guatemala, North Macedonia, Tunisia and Georgia. *Based on 2016 data, exceptions: Austria, 2014, Brazil, 2014, Albania, 2013, Kenya 2013 Tanzania 2014, Guatemala, 2014, Uganda, 2015, Tunisia, 2013, Colombia, 2015, Turkey, 2013, Peru, 2013, Portugal, 2012.
SOURCE: RF analysis of IMF, Public Sector Balance Sheet Database

[UK PSNW had fallen] from -42% of GDP in 2007-08 to -59% of GDP in 2019 – and was projected to peak at -83% of GDP in 2021-22. The UK's relatively large negative public sector net worth position is due in part to its elevated post-crisis level of debt. But it is also partly an artefact of the incentives created by the fiscal policy frameworks of the 1980s and early 1990s, which focused on reducing the volume of debt and minimising the public sector cash requirement. This encouraged privatisations of state-owned companies and sales of fixed assets such as social housing, even when these assets were sold below their retention value. This, together with the current deficits run over much of this period, drove a steady deterioration in public sector net worth between the early 1980 and mid 1990s. It also diverted the government's focus away from its steady accumulation of non-debt liabilities, including in the form of unfunded public sector pension liabilities and environmental clean-up costs.

Resolution Foundation proposals for a new fiscal regime

Reflecting both the lessons of the past and the challenges and opportunities facing policy makers in the decade to come, in 2019 the Resolution Foundation proposed a suite of three new fiscal rules designed to continue the progress towards Net Worth Accounting and address the failings of the current regime, without abandoning debt-based measures entirely.

1. **A net worth 'objective' to deliver an improvement in public sector net worth as a share of GDP over a fixed five-year term from 2020-21 to 2024-25**. This means that the growth in the value of the government's total financial and fixed assets needs to exceed that of its debt and other liabilities over the next five years as a share of GDP;
2. **A structural current balance 'target' to aim to achieve a cyclically adjusted public sector current balance of +1% of GDP and no less than -1% of GDP in outturn by the end of the fixed five-year period ending in 2024-25.** This would allow the government to borrow to invest (subject to the other two rules) but would require it to keep current receipts and current spending (including depreciation on its assets) in broad balance. To build in sufficient margin for error against breaching the lower end of the +/- 1% of GDP target range, the government would be expected to target a current surplus of 1% of GDP in each Budget up until the target year; and
3. **A debt interest 'ceiling' to ensure the share of total public sector revenue spent on debt interest does not exceed 10% at any time.** This would ensure that the overall debt burden remains sustainable by taking account of not only the volume of debt, but also its cost and the government's ability to service it.

In short, the use of PSND measures for fiscal targeting has had negative implications for UK policy making beyond the anti-investment bias discussed above. Most experts now agree that the UK government should continue to support the move towards Net Worth Accounting that is gaining ground around the world, as this will reduce policy-distorting fiscal illusions and provide the government with more complete information for making decisions. Even though the shift to Net Worth Accounting will not address all the deficiencies of debt-based measures, and will bring complexities of its own, at the least it will help change the public conversation about borrowing and investment, increasing transparency and accountability, and promoting greater awareness of the economic value of public assets. Adopting a more modern and comprehensive system of national accounts would clearly be a positive step that could complement wider changes to the accounting practice that should support more transparent and evidence-based decision making over the long-term, and begin to address the anti-investment bias fostered by the traditional focus on debt-based fiscal targets. That this is already the direction of travel for the ONS and OBR, and endorsed by the Labour leadership, is to be welcomed.

Recommendation 3: the next government should continue the progress towards Net Worth Accounting, increase its use in assessing the public finances, and include a Net Worth Objective in its fiscal rules.

2: Controls on housing providers' finances

Multiple systems of central control

Unlike those of private companies or housing associations, the public sector accounting system places great emphasis on the distinction between capital and revenue spending. Since public sector capital investment is largely provided through borrowing and delivered by local authorities, tight controls on council borrowing directly constrain the ability of the UK public sector to invest, particularly in capital-intensive assets like infrastructure and housing. Local authority borrowing is subject to control by both the general principles of the Prudential Code, and multiple specific Treasury controls on different aspects of their financial activities, which also limit local authorities' ability to on-lend to other types of social landlord, even where this would bring benefits for building and improving homes.

This section begins by discussing how central government control has suppressed local authority borrowing below prudential limits through an array of shifting policy mechanisms. We note how the UK's domestic subsidy control legislation constrains investment in social and affordable housing more rightly than international agreements require. We then consider how central government has made frequent, short-term and often badly-designed changes to its systems for setting rents, benefits, capital grant rates, the Right to Buy regime and other crucial policy inputs for social and affordable housing, undermining social landlords of all types by destabilising their operating environment and increasing the costs of delivering, managing and improving homes. Finally, we consider how governance arrangements for local authority landlords could be reformed to improve accountability and transparency without relying on the kinds of destructive control mechanisms outlined here.

The Prudential Code

Under the Prudential Code, each local authority is responsible for meeting its own liabilities, including those taken on through extending guarantees. The UK government provides no guarantee on local authority borrowing. Local authority capital financing decisions are subject to prudential guidance as published by the Chartered Institute of Public Finance and Accountancy (CIPFA), the Department for Levelling Up, Housing and Communities (DLUHC), the Scottish Government, and the Welsh Government. Taken together, these documents form the prudential framework.

Following consultation in 2017, DLUHC and CIPFA have updated their respective elements of the framework. Local authorities are required by statute to have regard to this guidance. These changes, which came into force in April 2018:
1) extended the requirement to consider security, liquidity, and yield in that order of importance to all investments, not just financial investments;
2) enhanced transparency requirements; required authorities to demonstrate how they have ensured that those signing off commercial decisions understand the risks and opportunities;
3) made it clear that borrowing more than, or in advance of, need solely to generate a profit is not prudential;
4) required local authorities to demonstrate that the level of debt taken on, and aggregate risk from, investments is proportionate to the size of the authority;
5) updated the guidance on calculating minimum revenue provision to make it clear that local authorities should not make imprudent assumptions to minimise their debt servicing costs.

The Prudential Code requires council borrowing to be linked to the council's ability to service the debt from its revenue streams, as authorities are prevented by law from using their property as collateral. For our purposes, the key features of the Prudential Code are that it has remained largely the same since its introduction in 2003, and that it does not include precise figures or caps on council borrowing, but allows each authority to determine its own borrowing limits in line with the principles of the code. This means that there is some flexibility in exactly how individual local authorities set these limits. The Prudential Code does not prescribe formulae for the exact calculation of prudential limits, so it is not possible to say definitively that an authority has calculated its limits correctly or incorrectly. The Code permits the authority to rely on the judgement of the local authority chief finance officer, and on 'generally accepted accounting practices'.

Local authorities are now in a theoretically strong position to borrow, within the broad constraints of the Prudential Code, to fund investment both within and outside of their Housing Revenue Accounts. The vast majority of stock-holding local authorities have interest cover above the 'golden rule' threshold of 1.25. Overall levels of debt remain well below equivalent levels for developing housing associations, with an average debt per home of £17,000 for local authorities compared to £30,939 for housing associations. Debt is also spread more evenly across local authorities compared to housing associations. Yet central government (above all the Treasury) has chosen to block local authorities from using this spare borrowing capacity to deliver housing and infrastructure, by imposing specific controls on the Public Works Loan Board and Housing Revenue Account systems over and above the constraints of the Prudential Code.

The Housing Revenue Account

Council housing is treated differently from all other local authority-owned assets in accounting terms. All stock-holding councils are required to keep the rental income from and expenditure on their housing assets in a Housing Revenue Account (HRA) that is ring-fenced from the General Fund, through which all other council cash flows are managed. Following government policy and incentives, since the 1980s many authorities have transferred all of their housing stock to housing associations, closing their HRAs in the process. Of 294 housing authorities in England today, 132 do not have an HRA, and of the 162 that do, some only have very limited stockholdings in PFI schemes.

Total debt held within the 150 HRAs that had published accounts in March 2021 was just over £25 billion, an average of £16,893 for each of the 1.49 million council homes held in these HRAs. Unlike private sector and housing association asset debts, the sustainability of HRA debt is not directly connected to the value of the assets acquired or developed, or even really to the quantum of debt, as these are social homes and are unlikely to be sold (though see the complications created by the Right to Buy, p.24 below). Instead, the sustainability of HRA debt is determined by the cost of servicing the debt and the amount of rental income available to cover these costs, after management and repairs have been accounted for – the 'interest cover' ratio. The informal 'golden rule' for HRA debt is that interest cover should be at least 1.25 – that is, that the amount of revenue left over after management, repairs and other costs have been allowed for should always be 25% more than the interest payable on the HRA debts. This is a very conservative rule of thumb (influenced no doubt by the strictures of the Prudential Code), and significantly higher than the 1.1 ratio that is the standard covenant rate that housing associations must demonstrate to their lenders.

In the national accounts, all HRAs are consolidated and treated as a single 'non-financial public corporation', which places their debts outside the General Government definition of national debt used for international comparisons, but inside the UK government's preferred PSND metric used for fiscal targeting purposes (see p.10 above).

Changing systems for controlling HRA borrowing

By far the largest single source of finance for local authority housing and infrastructure projects in England, Scotland and Wales is borrowing from the Public Works Loan Board (PWLB) at low rates linked to gilts. While recent PWLB rate reductions have made new HRA borrowing more accessible, this model of funding local authority housebuilding is still far less effective than it used to be during the post-war period of mass council house building, in part because a series of complex, centrally imposed systems have sought to tightly control local authority borrowing from the centre. Each of these systems has been driven by the political impulse to suppress the PSND measure of national debt, even at the cost of missing out on investment which would have supported higher rates of economic growth and lower public spending over the long-term.

The Rent Rebates and HRA system

Until April 2004, local authorities whose HRAs were projected to be in surplus (i.e. their rental income exceeded their costs) had their rental income from Housing Benefit reduced by the government. This meant that tenants not on Housing Benefit would in effect be paying the rent for tenants on Housing Benefit, a 'tenants' tax' that was highly controversial and was duly scrapped in 2003.

The HRA Subsidy System to 2012

The HRA Subsidy System that replaced it was equally complex and unpopular: this took Housing Benefit out of the calculations, but still redistributed funds between councils via a complicated formula administered by Whitehall, based on 'notional' costs and revenues of their HRAs. Few understood the system, dubbed the 'Schleswig-Holstein question of housing', and its annual calculations often produced surprising results, making local authority financial planning difficult. A core complaint was that it penalised councils that sought to build new social housing within their HRAs.

The self-financing settlement and the HRA debt cap to 2018

The HRA Subsidy System was duly scrapped by a process begun under the last Labour government and completed under the Coalition in 2012, when local housing authorities became self-financing in exchange for a one-off reallocation of debt between them. This reallocation was itself controversial, as it moved £19 billion of debt between councils, to avoid any debt being taken on by the Treasury. The calculation of debt reallocation was based not on their track records or choices but on how much debt their HRAs were deemed to be capable of servicing. This inevitably meant that councils that had managed their HRAs well and lowered their overall debt levels found themselves saddled with the debts of councils that had not. The settlement also imposed individual borrowing caps on each authority, and gave the Treasury 75% of all future Right to Buy receipts. Previously, local authorities had been required to set aside 75% of Right to Buy receipts to pay down HRA debt, reducing PSND figures at the expense of social housing supply. Many councils objected to the settlement, but others accepted it as a 'price worth paying' for freedom from the HRA Subsidy System. However, before the supposedly one-off reallocation of debt had even occurred, the Treasury announced that it would intervene to prevent councils borrowing more than it had anticipated – suggesting that the 'freedom' promised was strictly limited.

And so it proved, as this latest incarnation of central government control over the HRA system continued to generate additional complexity, uncertainty and repeated calls for reform. As interest rates and other indicators moved over time, the arbitrary national cap on HRA borrowing of £29.8 billion set in 2012, and the individual limits on HRA borrowing in each council, became ever lower than the limit the Prudential Code would imply on its own. By 2013, the Association of Retained Council Housing estimated that lifting the borrowing cap could enable £7bn of additional investment over five years, providing 60,000 homes. The caps were eventually lifted by Prime Minister Theresa May, in the face of strong internal opposition from Chancellor Philip Hammond and the Treasury, to signal the end of austerity and encourage the supply of social and affordable housing.

Recommendation 4: the next government should commit itself to not reimposing borrowing caps, redistribution mechanisms or any other system of complex HRA financial restructuring, relying instead on the principles of the Prudential Code to ensure councils' borrowing remains prudent.

Changing systems for controlling PWLB borrowing

Since 2018 local authorities have used their freedom from the cap to increase investment in housebuilding – yet their ability to make further use of low-cost borrowing to build homes and infrastructure has remained limited by the rules governing the repayment of existing PWLB loans, and changes to the terms on which they can take out new PWLB loans. Once again, these decisions have been driven by the Treasury's desire to limit new local authority borrowing for housebuilding based on the UK's unusual choice to use the PSND measure of debt in its fiscal rules. Local authorities have essentially escaped a blunt political cap on how much they could borrow under their HRAs, only to find their borrowing remains effectively capped by expensive historic PWLB debt and a series of politically-driven decisions that undermine certainty and good financial planning.

The combined effect of these decisions has been to disincentivise local authorities from proactively delivering new homes. Some have also prevented local authorities from paying off outstanding PWLB loans, unnecessarily inflating national public debt figures and producing mounting problems for local authority finances, with ramifications far beyond housing.

Despite all these restrictions, there has been a rapid growth in the volume and value of outstanding PWLB loans in recent years, so that £92bn in local government debt now sits on the PWLB's loan book. This increases the costs of doing nothing about the problems identified in this paper, and increases our opportunities to ease financial problems for local authorities and free up resources for affordable housebuilding if we act. It also demonstrates that the strategy of using complex and repeatedly changing rules imposed from Whitehall to limit council borrowing has not worked on its own terms.

The switch from incentives for early repayment of PWLB loans to penalties

Throughout the twentieth century, local authorities had an incentive to repay their debts to the PWLB early, but this was removed from 2008 and replaced by a system that has tended to penalise them for early repayment. Predictably, early repayment of PWLB debt fell from an annual average of £3.4 billion in the three years to 2010-11, to £186 million in the three years to 2015-16. It is now more difficult and less advantageous for councils to clear off old debts to make room for new borrowing that could finance new housing. Councils have continued to accrue capital to repay debts later, and while some of this capital has been used to reduce the need for external borrowing, or to lend to other councils, it has increasingly been invested externally until such time as the loans must be repaid. The National Audit Office has highlighted the potential risks of this practice (specifically the 'counter-party risk' that the institutions holding the investment may fail).

Crucially, many of the loans are also historic, with far higher interest rates that do not reflect the current costs of government borrowing. While housing debts are generally serviced from HRAs, other loan repayments are made through local authority general funds, which support the delivery of services. As these revenue budgets have been squeezed during the period of government austerity from 2010 onwards, the proportion of these budgets dedicated to meeting loan repayments has increased, adding to the budgeting pressure on council services including social care.

The impact on the devolution debate

PWLB loans are the principal source of finance for local authorities across England, Wales and Scotland. As the Treasury has increased its formal control over this finance - and has exercised this control through frequent, unpredictable rate changes which have undoubtedly damaged the financial position of local authorities - the politics of PWLB borrowing have sometimes become symbolic of broader frustrations with over-centralised decision-making in the UK. A 2022 investigation from Scotland's The Ferret found that interest payments on historic PWLB loans were costing Scottish local authorities over £400 million per year, equivalent to 15% of all council tax revenue in Scotland. The fact that the most expensive historic PWLB loans were taken out prior to devolution has been a particular source of ire for Scottish campaigners and trade unions. Changes to allow local authorities to pay down expensive historic PWLB debt could be a powerful symbol of a renewed government commitment to more local decision-making, liberated from unnecessary Treasury control.

In changing the early repayment terms of PWLB debt, Treasury aimed to ensure that local authorities would 'compensate' the PWLB where current interest rates are lower than rates were at the time the government issued the loan, avoiding any risk of the National Loans Fund running at a loss. In other words, the Treasury is insisting on maintaining fixed margins on PWLB loans made decades ago, imposing higher than necessary debt servicing costs on local authorities, while repeatedly changing other aspects of the financial framework as it sees fit. Of course, the government as a whole is committed to paying historic debts at the rates agreed when bonds are sold, but HMT itself regularly refinances debt when it makes sense to do: in its own words, 'the government takes decisions annually that enhance fiscal resilience by mitigating refinancing risk' in order to achieve its debt management objective. This objective is 'to minimise, over the long-term, the costs of meeting the government's financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy.' From the perspective of the national economy, it makes no sense to insist on local authorities paying higher debt servicing costs than is necessary.

Further, as local government debts are counted within both the PSND and GGND measures of national debt, doing so also undermines the Treasury's ability to meet its fiscal targets.

Recommendation 5: the next government should allow local authorities to pay down expensive older debt without incurring penalties. Local authorities should then be able to take out new PWLB loans to support housing and infrastructure projects at new, lower rates, within the limits of the Prudential Code, or to reduce their total levels of debt and debt service costs.

Higher and more volatile borrowing rates for new PWLB loans from 2010

During the 2000s, the PWLB tended to offer interest rates only 0.15-0.20% above the government's borrowing costs, but in October 2010 this differential was raised to 1%. From 2012, Treasury went on to introduce various conditional discounted PWLB rates for specific types of local authority projects, including lowering the rate for HRA borrowing to 0.8% over gilts. This eased the financial constraints imposed by the 2010 rate increase, but also introduced more complexity and uncertainty into the PWLB system.

In October 2019, the Treasury increased interest rates on new PWLB loans by one percentage point overnight. A letter from the Treasury to local authority finance officers explained the move was a response to the recent overall increase in local authorities' use of the PWLB - though it is likely that this decision was driven at least in part by Treasury concerns about the growing trend for local authorities to invest in commercial property (often outside their own areas) in the hope of securing rental income to replace central government revenue funding lost under austerity. This unexpected and immediate increase in finance costs caused some local authorities to scale back or delay housing and infrastructure projects, despite the urgent need for these projects, while others saw their finances worsen as they absorbed the cost of the unexpected rate rise.

While the rate for local authorities taking out new PWLB loans under their HRAs was brought back down in November 2020, the 2019 overnight rate rise has left a legacy of poorer local authority finances and decreased risk appetite. Most LAs now stress test their investments to ensure they are resilient to a sudden 1% change either way in the PWLB rate, so the 2019 higher rate is now effectively baked into LA investment decisions, if not their actual interest payments. While the Spring Budget 2023 decision to cut the rate of borrowing through the PWLB for Housing Revenue Accounts was welcome, the overall effect of these repeated changes has been to undermine the certainty around future PWLB rates, with inevitable consequences for the investment environment for social and affordable housing.

Recommendation 6: the next government should revert to the previous position of allowing LA borrowing via the PWLB at very small margins above base rates, and confirm a commitment to maintain rate stability for the long-term.

The complexity of HRA accounting creates practical challenges for LAs seeking to deliver projects directly

Many LAs are affected by what appears to be a general and ongoing shortage of audit capacity within the sector as a whole and particularly in relation to HRA accounting. Councils that have wanted to reopen a Housing Revenue Account report that it is very difficult to find accountants who understand how the HRA system works.

Increased complexity and uncertainty around loan rates has happened in tandem with the increase in Treasury control over the PWLB system. Following the government's decision in 2020 to abolish the Public Works Loan Board as an independent organisation and transfer its functions to HMT (to be discharged through the UK Debt Management Office), the rules governing the terms on which local authorities can pay off existing PWLB debt and take out new loans are now directly controlled by Treasury. Yet this Treasury control is failing on its own terms; it is blocking many prudent local authorities from building affordable homes and infrastructure to support local growth, while enabling and at points encouraging other local authorities to make risky investments.

Recommendation 7: the government should commit to keeping all the rules on HRA and PWLB as simple and stable as possible, to improve confidence, reduce skills barriers and enable more LAs to open HRAs. Any changes should be made following well trailed and transparent reviews involving all relevant stakeholders, not via overnight announcements.

Councils that lack an HRA are unable to access PWLB finance for new housing, as councils are restricted from on-lending to housing associations and other social housing providers

The general lack of housing delivery capacity and confidence among many local authorities, particularly those that lack an HRA, increases the imperative for a future government to work with the delivery capacity that exists and is delivering already. In many cases, and especially in the north of England where fewer councils have an HRA, this will be housing associations, supplemented by emergent capacity from community-led housing groups. Some housing associations are now being hit by rapidly rising finance costs, or are reaching their borrowing limits under their financial covenants. This is a particular problem for more regionally and locally-focused housing associations that do not have the same access to money markets as the largest national associations. By their nature, these associations have more geographically-concentrated stock, they are usually smaller and often have lower viability and governance ratings.

In places where the local authority has closed down its HRA, local authorities, housing associations and community-led housing groups will need to work more collaboratively to make the most of their collective capacity for delivering and improving homes. Joint ventures between different types of social landlord have become more common in recent years and are likely to be crucial to overcoming capacity and skills constraints in the years to come.

To support further collaboration, it would make eminent sense for councils to be able to borrow via the PWLB and to on-lend to housing association and community-led housing partners in their areas, smoothing out spatial inequalities in access to low-cost finance for social and affordable housing from PWLB across the country. While local authorities can already on-lend to community organisations, including housing associations, on-lending must comply with the UK's subsidy control legislation and international obligations. Experts consulted for this report emphasised that the UK has, through domestic legislation, restricted opportunities for councils to on-lend to drive social and affordable housing delivery more than is necessary under international rules.

Under the Subsidy Control Act 2022, public bodies can provide a total of £315,000's worth of subsidy over a 3-year period to most types of organisation without having to comply with administratively burdensome subsidy control requirements, using the Act's 'minimal financial assistance' exemption. Some local authorities are using this exemption to on-lend small amounts from PWLB for community-led housing projects, where they are confident that the difference between the rate they are offering by on-lending from PWLB and the rate the intended recipient could have accessed commercially will remain below £315,000 in value over a 3-year period. However, the £315,000 cap is far too low to make on-lending from PWLB a realistic option for financing social and affordable housing projects at the scale needed to tackle the UK’s backlog of need.

Experts consulted to feed into this paper have suggested that local authorities should instead be using the Act's Services of Public Economic Interest (SPEI) Assistance provisions to access a higher cap of £720,000 (over 3 years) for the amount of financial assistance they can make available to housing providers to deliver social and affordable homes. While still low in relation to finance costs for most housing projects, this higher threshold would no doubt bring more social and affordable housing schemes in scope to benefit from low-cost borrowing from PWLB, under the new terms we recommend on pages 17-19 above..

However, there seems to be some confusion amongst local authorities about how to comply with the Act. The Act also goes into more detail than the UK/EU Trade and Cooperation Agreement it replaced on how local authorities must demonstrate compliance with SPEI Assistance provisions, placing additional burdens on financially challenged local authorities. Whatever the reason, there seems to be little if any channelling of PWLB finance to support housing development led by housing associations or other third-sector housing providers seeking to deliver larger schemes.

Recommendation8: the government should clarify how local authorities can on-lend capital (including from the Public Works Loan Board) to not-for-profit civic bodies without breaching Subsidy Control rules, ensuring housing projects benefit fully from SPEI Assistance provisions. If necessary, the Subsidy Control Act should be amended to remove administrative and practical constraints to PWLB on-lending. The government should in all circumstances avoid setting its domestic subsidy control legislation with respect to social and affordable housing more tightly than international agreements require.

WTO Government Procurement Agreement

In an expert roundtable convened to inform this report, some attendees raised the risk that future investment in social and affordable housing at scale could run into Treasury opposition on the basis that it would fall foul of, or complicate, the UK's duty to comply with the World Trade Organisation's Government Procurement Agreement (GPA). Introduced in stages since 1980, the GPA requires the UK to open a proportion of the public sector to private sector competition via procurement.

The first stage of the agreement, implemented in 1980, related to utilities and construction. The Treasury decided to classify social housing as construction, and satisfied the agreement partly through the transfer of over 1 million social homes into private ownership through the Right to Buy between 1980 and 1990. Some experts consulted for this paper had concerns that the future expansion of the UK's stock of social and affordable housing could produce pressure to increase Right to Buy sales, or to find new ways to open the sector to private competition.

However, these experts emphasised that social housing need not be classified in the way the Treasury has chosen. Countries including Germany, France, Sweden and the Netherlands have used provisions in the GPA to partially insulate social housing from marketisation.

Changing systems for setting rents, benefits, grant rates, the Right to Buy regime and other crucial inputs

In June 2023, the National Housing Federation launched its campaign for a long-term plan for housing to significantly increase social and affordable housing supply. At the heart of its recommendations is a call for the next government to de-risk the sector by providing clear strategic direction and more certainty over its key policy and spending inputs. Beyond central government restrictions on social landlords' access to borrowing, there are a large number of other policy factors that critically affect the efficacy of the system for building, managing and improving social and affordable homes. Thirteen years of austerity and frequent policy changes have created an unstable operating environment for both local authorities and housing associations, limiting what they can deliver.

Social landlords have seen their business models attacked from all sides through rent cuts, rent caps, changes to benefits payments and eligibility, reduced capital grant rates, and frequent changes to planning rules which have often reduced development opportunities for social landlords. Now, changing economic conditions have increased the costs and practical challenges of building and improving homes. Coming on the back of years of weak and inconsistent central government policy and funding support, this situation leaves social landlords worryingly exposed. In response to capital grant cuts, housing associations in particular have increased their use of the 'cross-subsidy' model since the last downturn: building market homes and channelling the profits from this into affordable housebuilding. As a result, they are now more exposed to a housing market downfall than at any point in the past. Many housing associations are already mothballing sites due to rising construction costs and softening market prices.

Social landlords have repeatedly appealed for certainty and longer-term settlements around the crucial inputs for building, managing and improving homes. UCL research funded by the National Housing Federation, Shelter and the Consortium of Associations in the South East has emphasised the inefficiency of the government's current approach to social housing policy, with uncertainty around rents, benefits and grant levels in particular leading to pronounced peaks and troughs in the delivery of new homes. This increases costs per home delivered, reduces overall affordable housing delivery, and undermines social landlords' ability to keep delivery moving as market conditions weaken: the counter-cyclical affordable housing supply on which the historically high housing output of the postwar period rested.

Rent setting in social housing

The recent history of social rent policy illustrates just how remote the goal of a stable and certain operating environment for social landlords remains; since a significant share of total social rent revenue is paid via Housing Benefit, the Treasury has made increasing use of social rent policy as a tool for reigning in public spending on benefits. More than 70% of total turnover for the social housing sector is generated from rents in social and affordable housing, so new and unpredictable risks to this income - whether from changes to rent setting policy or from changes to benefits policy - have a significant effect on social landlords' capacity and appetite to invest in new development or substantive improvements to existing homes. Housing association experts consulted for this paper strongly emphasised the importance of policy stability, pointing in particular to central government's decision in 2015 to scrap a supposedly 10-year rent settlement after just one year, which had a direct impact on associations' credit ratings and thus on their finance costs.

Rent setting in social housing
From 2002-2015, governments pursued a rent convergence policy in social housing, with the aim of reducing differences in rents charged for similar homes in similar places. Social landlords could increase rents annually by the Retail Price Index plus 0.5%, with many allowed to charge an additional £2 per week as part of the convergence policy. While this settlement left social tenants facing above-inflation rent increases which were not always affordable, it allowed local authorities and housing associations to predict how their rent revenue would change and plan for growth. During the 2013 Spending Round, the Treasury announced a new 10-year rent settlement for social housing; from 2015-16, all social landlords would be able to raise social rents annually by the Consumer Price Index plus 1% for 10 years. This was quickly followed by the announcement of the end of rent convergence from the then Department for Communities and Local Government, one year earlier than planned. While the end of rent convergence concerned some social landlords, overall the sector welcomed the certainty promised by the 10-year settlement. In the event, the 10-year rent settlement lasted just one year. In the 2015 Emergency Budget, the Chancellor announced that social rents would be reduced by 1% a year for four years, starting in April 2016, resulting in a 12% reduction in average rents by 2020-21 compared to what had been projected under the previous rent setting formula. The measure was forecast to save the Treasury £1.4 billion by 2020-21, primarily in reduced Housing Benefit expenditure. The sector Office for Budget Responsibility (OBR) predicted an overall reduction in housing investment as a direct result of the policy. In 2017, the government announced a new rent settlement: from 2020-21, social landlords would once again be permitted to increase rents annually by the Consumer Price Index plus 1%, this time for five years. Yet, once again, a rent settlement which promised to improve the predictability of social landlords' operating conditions proved to be short lived. In response to rising inflation and an emerging cost of living crisis - to which many social tenants were vulnerable because of lower-than-average household incomes in the sector - the Autumn Statement 2022 announced that rent increases would be capped at 7% in 2023-24, instead of the maximum increase of 11.1% which the CPI+1% formula would have been delivered.

The 7% cap has been largely welcomed by social landlords and will produce better financial conditions than many of them were expecting, but it nonetheless represents one more step away from a stable and predictable operating environment for social landlords, and will no doubt affect confidence in future government commitments on rent policy - amongst both social landlords and their creditors.

Benefits policy

Central government decisions on how social landlords can or must change rents each year represent one side of the coin for determining rent revenues in social housing; the other side is changes to benefits entitlements for households living in social housing. Housing benefit has at points been considered a quasi government income stream, one which was secure and which ensured that rent levels in social housing would be affordable for tenants and that rents could therefore be collected in full. This has underpinned housing associations' access to lower-cost commercial borrowing, as social housing has been considered a low-risk investment option. Yet in recent years both the perceived and real security of social housing rent revenues have been undermined by a raft of central government initiatives to reduce or remove support to meet housing costs through the benefits system, and uncertainty over whether and how benefits payments will be uprated in relation to inflation each year.

From 2012, the government: replaced six benefits (including Housing Benefit) with Universal Credit, whose design delayed and reduced benefits payments in a number of ways; introduced the household Benefit Cap; introduced the Removal of the Spare Room Subsidy (commonly known as 'the Bedroom Tax'); and made various other changes to the benefits system as part of austerity. The impacts of these changes on social tenants and social landlords have been severe. A 2020 Smith Institute research report commissioned by Southwark Council found that tenants in London build up an average of £240 of rent arrears after they make a Universal Credit claim, significantly undermining the predictability of rent revenues and causing stress and hardship for households who get into rent debt.

Uncertainty over whether benefits will be available to meet social tenants' housing costs is ongoing, particularly as inflation has accelerated since 2022. Research from the Joseph Rowntree Foundation demonstrates the long-term failure of benefits uprating to match real levels of inflation in the economy, and the impact this has had on the value of benefits payments over the decades. In a period of higher inflation rates, it is crucial that the next government gives more certainty to both households and social landlords about how support with housing costs through the benefits system will change with the rising costs of living.

Yet further disruption to social landlords' business plans has come from the many other changes to social tenants' rent levels and benefits entitlements which central government has proposed, legislated for and then decided not to implement in recent years. These unfulfilled attempts to alter the crucial inputs for social housing have had real, material impacts for investment in new affordable housing supply. As just one example, the government's 2015 proposal to cap housing benefit entitlement for all tenants of social and supported housing to the level that would be available for private tenants - the so-called LHA Maxima Cap - led to a rapid collapse in new supported housing supply. A 2017 National Housing Federation survey of its members found that 85% of planned supported housing developments had been cancelled over the preceding year. Ultimately, the government proposed various exemptions from the LHA Maxima Cap for supported housing residents, before scrapping the policy entirely in late 2017. But by this time significant and permanent damage had been done, with communities missing out on much needed supported housing that would otherwise have been built.

In these conditions, regular news of new credit rating downgrades for housing associations should not surprise us; the sector's risk profile has increased, and communities across the country are paying the price as higher borrowing costs for social landlords hamper their ability to deliver new homes and to manage and improve existing ones. These factors have driven declining financial resilience and increased risk for social landlords, contributing to the ongoing trends for housing associations to: 1) merge in search of efficiencies of scale; 2) increase their use of the 'cross-subsidy' model, building market homes and channelling the profits from this into affordable housebuilding, and so increasing their exposure to housing market volatility. These shifts have been unpopular, and have contributed to a growing sense that social landlords in general, and housing associations in particular, have lost their way.

The Right to Buy

The Right to Buy has clearly been a major factor in the long-term decline in social housing. Not only does it reduce the stock of social homes (by around 14,000 homes a year at present), it also introduces yet another element of uncertainty into council landlords' business plans.

The Right to Buy regime

Scotland ended the Right to Buy in 2016, followed by Wales in 2017, while moves to end the policy are ongoing in Northern Ireland. In England, the Right to Buy regime continues to weaken HRA business plans, as councils may at any point have to sell homes at well below market rates, impacting on their balance sheets. Complex and frequently changing rules then govern their use of the receipts from sale.

The share of capital receipts automatically taken by the Treasury was recently reduced from 75% to 0% for two years, and while stock-holding local authorities warmly welcomed this change, they also emphasise that this two-year reprieve from the full effects of Right to Buy does little for their ability to address the large backlog of housing need in England that has built up over many years. A range of further restrictions on how and when councils must reinvest their share of Right to Buy receipts remain, such as the requirement for councils to fund no more than 40% of the costs of a new home through Right to Buy receipts - a requirement that is easier to meet where councils have good access to capital grant and cross-subsidy from building market housing, which is not the case for all councils at all times.

If councils fail to spend Right to Buy receipts in the ways and within the timeframes central government has determined, the receipts revert to central government - except in London, where unspent receipts are pooled and held by the Mayor of London until councils are able to spend them. This is a welcome result of faster devolution of housing policy and funding in London compared to other parts of England. Constantly shifting rules ensure at least some councils outside of London will continue to send unspent receipts to the Treasury, in amounts that they cannot reliably predict, with damaging impacts for business planning. In 2021, the Chartered Institute for Housing estimated that over 40 years the Treasury had received £47 billion from Right to Buy receipts.

Housing associations remain outside the Right to Buy regime (with a smaller-scale Right to Acquire operating for some housing association tenants), though the Conservative Party has for many years pushed for an extension of the policy to housing association stock - most recently in a speech from then Prime Minister Boris Johnson in June 2022. While central government is unlikely to be able to force housing associations to sell homes through the Right to Buy on terms as damaging to business plans as those for local authorities, the possibility of a Right to Buy extension to housing association homes remains a lingering source of risk.

Removing or reducing this uncertainty would clearly improve councils' ability to plan, borrow and build. Yet the principle of enabling social tenants to purchase their homes at a discount remains extremely popular in England. Research conducted in 2018 for the Affordable Housing Commission, chaired by Lord Best, found hostility to ending the Right to Buy amongst lower-income *private* renters, as this would deny a right to a family living in social housing who had 'done all the right things'. Evidence from the British Social Attitudes Survey in 2011 found the public saw the option to exercise the Right to Buy as the main advantage to living in social housing.

There are a number of options for reforming Right to Buy in ways which would help reverse the decline of social housing, short of abolition. There is potential to reform the precise level of the discount, conditions for eligibility, the amount of sales receipts local authorities keep to reinvest in new social housing, and conditions on how Right to Buy properties can be sold on and converted into homes for rent. For example, the Local Government Association has long campaigned for councils to set Right to Buy discounts locally, and to retain 100%of sales receipts to fund replacement social homes on a permanent basis.

The critical point about all of these inputs into the housing system is that, just as with the rules applying to PWLB loans and HRAs, uncertainty about future policy changes has an impact above and beyond the actual rates of rent and grant that are available. The 30+ year business plans of social housing investment rely on borrowers having confidence that the inputs into those business plans will remain stable. All of these policy factors also impact on banks' and private investors' willingness to lend to social housing providers, including housing associations, and so have implications far beyond the efficiency of the HRA and PWLB systems.

Recommendation 9: government should seek to increase borrower and lender confidence alike by committing to longer-term stability and predictability of the rent, welfare and grant regimes. Specifically, government should:

- ***Increase the duration of Affordable Homes Programmes from five years to ten and commit to additional funding to boost the programme on a per unit and per annum basis.***
- ***Give councils and smaller housing associations the same long-term grant packages as the larger associations deemed 'strategic partners'.***
- ***Peg capital grant rates in the Affordable Homes Programme, Social Housing Decarbonisation Fund and other pots to an inflation index (ideally Building Cost Inflation).***
- ***Commit to longer-term rent settlements that are more resilient to economic change. Above all, rent settlements must last for their intended period, i.e. a 10-year rent settlement should last for 10 years. If straying from a long-term settlement in one year becomes truly unavoidable, rent policy should be adjusted in subsequent years to ensure social landlords' revenues are stable and predictable across the period of the settlement.***
- ***Commit to uprating benefits payment levels every year in line with the Consumer Prices Index.***
- ***Allow councils to keep 100% of their Right to Buy receipts permanently, without restrictions on how they can deploy them within their HRAs, and give them greater freedom to adjust Right to Buy eligibility and discounts in their areas.***

Governance of council landlords

Relaxing Treasury controls on the PWLB and HRA systems means relying on the Prudential Code to prevent irresponsible borrowing by councils. The history of these strategies for control demonstrate that, in general, it is better to rely on good governance (which grows capacity and confidence over time) than on micro-management from the centre (which destroys capacity and confidence over time and doesn't work as a control mechanism anyway). Applying this principle to the social housing sector suggests that, at the same time as moving away from arbitrary rules and caps on councils' financial activities, central government should ensure that council housing governance is fit for purpose.

Governance arrangements are currently very different for council and HA landlords. Housing associations are scrutinised by the Regulator of Social Housing, and failures are high profile and often career-ending for CEOs and board members (e.g. Rochdale Boroughwide Housing). By contrast there is far less scrutiny of council landlords' governance, as the democratic process is intended to provide sufficient incentive to ensure good management. However, as some high-profile recent cases have demonstrated, the electoral imperative has not proved sufficient and the absence of more formal checks and balances has allowed breakdowns in service performance and failures to properly manage assets by councillors who may have lacked the knowledge and experience to provide adequate oversight. The extension of the consumer standard, the new competency and conduct standard and the mandatory qualifications requirement to councils will start to address some of this gap, but the regulator will still not have the same purchase on governance and viability as it does over housing associations. If council housing is to return as a major source of new supply it will need to be more robustly governed.

One potential approach would be to give elected councillors a more explicitly strategic role suitable to their political status. This would involve setting strategy and appointing a board, including a prominent role for tenants and residents as well as professionals, which would have responsibility for both day-to-day services and long-term asset management. This process should draw on evidence and best practice on successful resident involvement from across the country and beyond; for example, North Star Housing Group in the North East has developed strong practices and processes for involving residents over many years, putting tenant voice at the heart of the association. This would help give council tenants greater assurance that their homes will be well looked after – and would also improve the ability of councils to borrow from the PWLB and private markets alike, as both Treasury and investors could be confident that borrowing was in independent, competent, hands.

Recommendation 10: the next government should seek to introduce a new governance framework for council housing that would give tenants and residents a greater role in oversight, and ensure professional long-term management of HRA assets.

3: Controls on spending

As discussed above, central government tightly restricts the ability of local councils and housing associations to raise money for investment. This, and the strict limits on councils' fiscal autonomy to raise money from taxes, keeps providers largely dependent on grants from central government – and here again a raft of complex, opaque and constantly shifting control mechanisms slows down, complicates and blocks spending.

Allocations to departments

Spending Reviews, which cover roughly half of government spending, including the bulk of capital investment, are a distinct improvement on the chaotic annual budgeting processes that preceded them, but these have still proved far too prone to political interference to provide a sensible and stable framework for planning public investment. Successive governments have been unable to resist the temptation to move the timetable to suit their political ends, so that even the duration of Spending Reviews has proved unstable, ranging from 1 to 5 years in an almost random pattern of 2,2,2,3,3,2,4,2 and 3 years respectively between 2001 and 2021. Nor does the SR process – in which departments must argue their case to the Treasury for funding – bear any direct relationship to the political process for setting government priorities via manifestos. As long as the allocations process has no formal statutory status, the interests of good governance and accountability will always be overruled by short run political imperatives to move programme timetables and hold back decisions to create 'announceables' at Budget, party conferences and other set political moments.

The Commission for Smart Government has argued persuasively for abolishing the SR process and replacing it with a Plan for Government with up to five goals for changing or improving the country, defined by clear metrics for assessing the change to be achieved by the end of the Parliament. Departmental performance plans would then follow on from the Plan for Government, matching allocations directly to the funding and delivery of central government's strategic priorities. This would also help address failures of accountability in the UK system. Experts consulted for this research identified the centralised nature of spending decisions as a factor that makes holding the government to account against its stated priorities largely impossible. Accountability is officially held by Secretaries of State, who are too far removed from day to day delivery to exert real control over the decisions that they may be held accountable for. The result is that ministers tend to rely on HMT spending controls to limit delivery risks, reinforcing the anti-investment bias and tendency to centralise control via financial mechanisms.

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Recommendation 11: replace irregular Spending Reviews with a longer-term strategy matching allocations and delivery plans to a limited number of clearly expressed government priorities.

Spending by departments

Even once funding has been allocated via the Spending Review process there is no guarantee that it will actually be disbursed to delivery agencies and local government, as there are multiple opportunities for the governmental 'centre' (Number 10, Cabinet Office and above all Treasury) to restrict both allocations to departments and then even relatively small spending decisions by them. For example, until early 2023 DLUHC's Secretary of State could approve spending on capital projects up to £30 million within programmes that had already been approved by the Cabinet. Anything above that limit would require specific Treasury approval. Treasury removed even this limited autonomy overnight in February 2023, citing 'concerns about value for money', meaning that even the smallest capital investment projects have to be passed all the way up a chain of control from the frontline agency or council delivering it, via DLUHC officials and ministers, to the Treasury and the Chancellor of the Exchequer. Whether these VfM concerns are justified or not is hard to assess, as the Treasury has given no public explanation for this decision. But it will undoubtedly worsen the already severe blockages in the system: by November 2022 only a third of the £4.8 billion Levelling Up Fund had been allocated and just 5% actually spent since it was announced in 2020.

The same pattern of arbitrary central controls and a lack of transparency delaying agreed spending can be seen in the flagship Shared Prosperity Fund, intended to replace EU funds post-Brexit. The three year fund was launched in April 2022, and every local authority received a 'conditional allocation' based on matching the EU funds it previously received - determined mainly by population. Yet, having decided on a population-based approach to allocations rather than Treasury's preferred approach of competitive bidding, central government then reintroduced many of the problems of competitive bidding by the back door through an opaque assessment process to confirm the measurable outcomes local authorities should target with their eventual allocations - which were significantly delayed. Successful councils had just three months to actually spend a year's funds, and had to submit yet another round of paperwork to allow the money to be rolled over to the next financial year. According to the Financial Times, a 'senior Whitehall insider said it was unclear why the government, having instituted a relatively light-touch process for clearing allocations, had then added another layer of bureaucracy to roll over funding into the next financial year. "No one's sure why they create these odd processes," the insider added.'

Underspends and clawback

The result is that underspends on major programmes are a common occurrence, often resulting in the Treasury clawing back funds. In September 2022, the Telegraph reported that DLUHC was developing emergency plans to spend a £1.5bn projected departmental underspend, but was struggling to find projects which would pass Treasury's appraisal methods (discussed below) on which to spend the money, and so avoid having to return unspent budget to Treasury. It is hard to avoid the conclusion that underspends suit both the Treasury, as they reduce outlay and retain its overall fiscal flexibility, and politicians at the centre of government, who can re-announce the allocation of the same funds with a slightly different focus and message to suit the current political context.

Local and project spending

At the local level, spending is even more tightly controlled. Central government determines by law which functions councils must provide, leaving only modest room for local discretion. Local councils are responsible for delivering over 800 services ranging from adult social care to environmental health, libraries to trading standards, children's services to highway maintenance and from public health to planning. In the context of central government's austerity drive from 2010, the share of local authority budgets dedicated to delivering statutory services has grown, with the share of spending on social care alone rising from 34% of local budgets in 2010-11 to 38% in 2019-20. As noted above, central government's decision to start penalising early repayments of PWLB loans from 2008 has piled yet further pressure onto local authority finances, as a growing share of councils' revenue budgets have been absorbed by PWLB loan repayments since this time. Given these spending commitments and councils' limited options for raising additional revenue through council tax and fees, most local authorities have had extremely limited discretion to fund local housing and placemaking projects in recent years - unless they have succeeded in convincing central government to award them additional funding.

Multiple, short-term funding pots

Where central government makes funding available to local authorities and other local delivery bodies, this funding is often insufficient to deliver on policy objectives, as funding puts are too small, too short-term and too discretionary to allow local agencies to rebuild capacity after a decade in which public services and community infrastructure have been pared back by austerity. As a result, the people and the places most in need of central government funding are at high risk of missing out.

These funding pots are generally run centrally from Whitehall and can only be accessed via competitive bidding. In theory, this supports better value for money from public spending by ensuring only the worthiest proposals receive public investment. In practice, it ensures that funding continues to flow disproportionately to those councils with the resources to prepare multiple proposals to the standard required to win competitions and, in turn, consistently disadvantages local authorities with more constrained resources. Since 2010, austerity-driven cuts to local government budgets have been unevenly distributed across the country, further entrenching spatial inequalities. The Johnson government did provide some additional funding to help with the costs associated with bidding for some levelling up funds, but this has been insufficient to overcome the significant imbalances in resources and internal expertise between different local authorities. Karbon Homes' recent *The Case for Place* report argued for the UK government to proactively address long-term inequalities in the distribution of funding for public services, so that public investment can fill in the gaps left by private investment rather than replicating them.

A related problem noted in the Treasury's 2020 *Green Book Review* is the lack of transparency around how public investment decisions are taken, beyond ranking the Benefit Cost Ratios of different proposals (discussed below). This has encouraged local authorities to rely on external consultants specialising in boosting BCRs when preparing competitive bids for public investment, adding to the problems of resourcing high-quality bids for local authorities with the most constrained budgets, and risking the further erosion of internal expertise in bidding authorities. Experts consulted for this paper emphasised the arbitrary nature of Treasury control over evidence standards in competitive bidding, with one expert suggesting, "What counts as good evidence in the Treasury's eyes is evidence that agrees with the things that they thought of in the first place, and what counts as bad evidence is whatever disagrees with them." Experts also emphasised that this Treasury control over spending decisions and the standard of evidence needed to access funding regularly produces a lack of sensitivity to local conditions and local needs in policy-making, as different proposals for funding for different places are often being prepared by the same consultants and then assessed by the same Treasury officials, leading to similar proposals to fund similar types of intervention in very different places.

Research by RIBA suggests that the fragmented nature of the present funding landscape makes coordinated strategic planning for regeneration and growth difficult. Resourcing successive bidding rounds is demanding on officer time and capacity. Different priorities between these funds often means that bids are written to secure the funding, rather than to achieve the optimal overall objective of achieving the potential of a place. Competitive bids for project funding must instead be judged according to technical and/or political criteria. As Councillor Abi Brown, leader of Stoke on-Trent City Council, put it in a recent essay for the Centre for Inequality and Levelling Up: "If true levelling up is to be achieved, it will not be through a succession of beauty parades for small pots of cash for centrally directed pet projects. It will be secured by one joined-up conversation, a commitment to long-term partnerships, to a shared vision of what cities like Stoke-on-Trent can become, and the resolve and funding to see it through." The pitfalls of relying on a centralised competitive process have also been recognised by the Industrial Strategy Council and by the Business, Energy and Industrial Strategy Committee.

Recently, central government has attempted to respond to these weaknesses in its spending processes, with mixed results. To allocate £9 million of Levelling Up Parks funding in August 2022, the government identified 85 local authorities using data from Natural England and the Index of Multiple Deprivation to assess the need for more and better outdoor space. The size of the fund is small, particularly in relation to the scale of cuts to local authority spending on parks since 2010, yet the move towards more needs-based spending decisions is welcome. The ongoing debacle of the UK Shared Prosperity Fund (discussed above) shows how, even when the government had decided to allocate funds on a needs-based formula instead of competitive bids, the culture of centralised control reasserted itself as councils and charities had to wait months for their 'conditional allocation' to be determined via an opaque and burdensome 'assessment process', and were then given only three months to spend a years' funding or see it clawed back.

Recommendation 12: the government should replace short-term, competitive pots for narrowly defined programmes with longer-term, needs-based funding formulas that will give communities across the country the confidence and capacity to embark on bold, joined-up investment plans.

Recommendation 13: to ensure public money is properly spent, councils and delivery agencies should be subject to proper audit and scrutiny of their spending of the funds allocated to them, reducing reliance on competitive bidding, project appraisals and clawbacks.

Restrictions on access to funding

In a similar vein, conditions attached to government funding – often with the intention of ensuring good value for public money – effectively exclude some communities from programmes relevant to their needs. This might be because local authorities with tighter finance or internal capacity constraints face additional challenges in demonstrating that central government conditions have been met, because deprived places cannot rely on the same mix of funding from different sources that is available to prosperous places, or simply because Treasury conditions are inappropriate for meeting some places' needs.

For example, a recent report from the Public Accounts Committee expressed concern that the deliverability requirements attached to levelling up funding may have combined with delays in central government decision-making to result in good proposals for investment being compromised or rejected, while other proposals of less merit may have succeeded in accessing public funding by being overoptimistic about their delivery timescales.

Work from CEBR for Homes for the North gives two further instructive examples of this problem:

- A Future High Streets Fund bid was challenged by the requirement that no more than 5% of the money be spent on beautification (i.e. improving the public realm). Whilst this may be appropriate for some areas, in others, very poor public realm can act as a barrier to growth such that addressing it may be a highly effective use of public resources.
- In the case of a town centre bid (including residential and mixed-use components) that was successful in securing funding, an arbitrary 'top slice' was applied by the Treasury, meaning that only 70% of the funding bid for was provided. This meant that a carefully designed scheme had to be substantially reprofiled, which was in itself costly and inefficient.

Karbon Homes' *The Case for Place* report describes the impacts of central government's rules and conditions for accessing public funding on their ability to deliver, manage and improve homes in their home patch of the North East, a region which is particularly affected by the problems described here because it contains high concentrations of deprived neighbourhoods with low housing demand, because many developable brownfield sites come with high remediation costs, and because councils in the North East have been hit especially hard by austerity. Lower housing demand in much of the north and midlands of England means social landlords rarely have the option to generate significant cross-subsidy from building market sale homes in left behind places — a frequent strategy for funding building and placemaking improvements in social housing in places with higher property values. Yet there are hard limits to the difference social landlords can make while relying on their own revenue and reserves, given the sheer scale of investment needed across many communities. Gap funding from central government is essential if investment is to take place in these market conditions - yet the places most in need of public investment to kick-start regeneration are precisely the places blocked by Treasury control.

Recommendation 14: the next government should in all cases avoid placing unnecessary conditions on local delivery bodies' access to funding, and should assess the spatial and other equalities impacts of any proposed conditions on access to funding when designing funding prospectuses.

Net additionality in the Affordable Homes Programme

The Treasury's insistence that housing projects funded through the £11.5bn Affordable Homes Programme 2021-2026 must deliver 'net additionality' is frequently cited by social landlords as a key barrier to delivering on central government's policy objectives in deprived places. Funding is available only for 'net additional homes' on regeneration projects, i.e. new build dwellings above and beyond the original number of homes on an estate. The fund explicitly excludes works on existing homes – however old or unfit-for-purpose. Even the Recycled Capital Grant Fund (the mechanism used to reinvest historic grants which become available when, for example, supported housing is converted to general needs social housing) is subject to the same restrictive rules as the AHP, and so cannot be used to fund retrofitting or other works on existing homes.

This focus on short-term additionality may make sense in the context of high-demand housing markets, where the primary need is to increase housing supply and there is typically more demand for the higher density, flatted development that higher prices can support. But it is simply inappropriate in less economically productive places, which often lack the housing demand necessary to densify estates in the ways net additionality funding conditions require – and where in any case the social need is often for less intensive housing forms, such as family housing or older people's accommodation. Densification of existing housing estates does not make financial sense where there are clear signs of housing market failure (such as high or rising numbers of homes not in use). Equally, it may not be realistic to expect housing demand to increase – and thus enable net additionality requirements to be met in future – without improvements to the quality of homes, placemaking and local infrastructure, themselves dependent on access to public investment.

These distortions in the framework for public investment in housing produce a high risk of poorer placemaking, slower modernisation of buildings and spaces, and slower build out rates, particularly in regions with lower demand housing markets. The result is stagnation of the built environment, which research has linked to adverse health outcomes, increased hospital admissions, higher rates of fuel poverty, and missed opportunities to improve local employment opportunities. Yet despite their obvious social and economic costs, these costs of under-investment are not adequately accounted for in the appraisal methodology Treasury uses to make spending decisions, as the next sub-section will discuss.

Recommendation 15: the next government should increase the flexibility of the Affordable Homes Programme and other Homes England funds, ensuring that capital grant can be spent on acquiring, retrofitting and refurbishing existing housing stock in places where 'net additionality' rules are not appropriate because of lower market demand.

HMT appraisals

To win funding allocations and then to secure approval to spend any allocated funds on actual projects, councils and other delivery agencies are subject to Treasury appraisals using its Green Book methodology. This is often blamed for blocking public investment in housing and placemaking and for skewing it away from deprived places and towards the places where housing demand is highest:

- Despite numerous attempts to broaden its focus to take more account of social and wellbeing outcomes, the Green Book continues in practice to privilege narrow UK-wide Benefit Cost Ratios (BCRs) above all other considerations in spending decisions. In particular, the potential social value and wellbeing impacts of investment proposals have tended to be under-emphasised in Green Book appraisal, both because it has not always been clear which social value and wellbeing impacts are valued by decision-makers – i.e. the outcomes investment should achieve have not been clear enough – and because metrics to capture these impacts are under-developed. The Treasury's July 2021 Wellbeing Guidance for Appraisal supplementary guidance sets out recommendations to incorporate robust, causal estimates of wellbeing within cost benefit analysis, yet the evidence base which could support such a robust assessment of social value in many cases simply does not exist. Experts consulted for this paper told us that the evidence required by the Treasury may also be deliberately obscure or changed at short-notice to fit in with a political decision that has already been made.

- As the Treasury's 2020 Green Book Review acknowledges, a BCR may be based on evidence which itself is incomplete, has limited applicability to local conditions, or covers an insufficient time horizon to account for full project costs and benefits. For example, the Green Book assumes that employment impacts from most spending decisions will generate zero additional employment, on the basis that any local increase in jobs is likely to displace economic activity from somewhere else in the country. Making the case for investment in local regeneration projects in places with low recent growth on these terms is extremely challenging.

- Green Book appraisal remains focused on outdated, static models and narrowly measurable factors which fail to properly account for the dynamic effects of place improvement. Better places attract more people, who attract more business activity, which stimulates investment – yet these effects are explicitly excluded from the core Treasury methodology for assessing whether investment is worthwhile. This leads it to emphasise hard, measurable costs and benefits based on current market prices (especially land value increases) over more complex outcomes like economic growth or improved public health – and therefore works against decisions to invest, particularly in more deprived places. This issue has been summarised eloquently by economist Diane Coyle as a problem of the Treasury 'being able to add up but not to multiply.'

The Whitehall obsession with UK-wide BCRs based on these assumptions means that public investment tends to follow private, worsening rather than countering geographic disparities, and leaving large swathes of the country stuck in a vicious cycle of low value, low investment. For example, of the £57.8 million allocated from the Brownfield Release Fund in October 2021, local authorities in the North East, Yorkshire and the Humber and the North West received 4%, 4% and 2% respectively. Local authorities in London, the South East and the South West received 15%, 25% and 26% respectively, despite far higher house prices in these regions making brownfield development more viable without government funding.

Beyond the Green Book's role in exacerbating and perpetuating spatial inequalities, the current assessment of BCRs is also inherently hostile to investment in social housing, and it undercounts the financial benefits of housing lower-income households in social housing rather than in more expensive alternatives. One expert consulted to inform this paper described how the Green Book assumes that new social homes will actually *increase* spending on housing benefits, on the basis that some will be used to house people who were previously living in overcrowded or 'hidden' households, and may therefore have had limited or no entitlement to housing benefits. This approach to appraisal ignores the significant financial benefits of using social housing over temporary accommodation, which cost English local authorities at least

£1.6 billion in 2021/21, not to mention the savings to the benefit bill from moving households from the private rented sector to social housing. DLUHC's own evaluation estimates that every £1 invested in social housing delivers at least £2.70 of economic benefits. But 89% of this measured benefit comes from land value uplift – which is not the objective of social housing at all – strongly suggesting that the official methodology is failing to measure the right outcomes, and reinforcing the bias towards investment in richer areas.

More research into social value and wellbeing measures is needed to fully capture the holistic impact of investment decisions on people's quality of life. This would enable the Treasury's Wellbeing Guidance for Appraisal to be put into action in decision-making, for example, through better, more holistic evaluation of current and recent public housing and placemaking projects which can then inform future spending decisions. In the meantime, it is critical that the government finds better ways of accounting for social value in decision-making based on available evidence.

Recommendation 16: the next government should look beyond narrow metrics of value like BCRs to include the dynamic economics of placemaking and the wider impacts of social infrastructure in financial appraisal systems. Specifically, the next government should support and encourage the development of robust social value reporting frameworks to enable more rigorous monitoring and evaluation of spending and policy interventions in housing and placemaking.

The role of devolution in challenging Treasury control

Experts consulted to inform this paper suggested devolution could provide a way to pilot more delegated, joined-up and place sensitive budgeting, potentially easing many of the problems we have identified. It may be easier to move powers from HMT to Greater Manchester than it is to promote power-sharing between different central government departments, or between central government and local government. The devolution of powers from Westminster to the Scottish Parliament and the Welsh Assembly has been broadly positive for housing investment and outcomes (although decision-making in Northern Ireland remains constrained by the breakdown of power sharing in the Assembly). Beyond this, there is already a degree of momentum behind the drive for greater devolution within England, and an emerging alignment among the elected metro mayors of the north and midlands as they demand more powers and funding from the government. Mayoral devolution currently covers 41% of England's population, 49% of its economic output, and 14% of the land area. If the five devolution deals concluded in 2022 are implemented, this will increase to 51%, 57%, and 33% respectively in 2024, meaning the majority of England's population will have a mayor for the first time. The next government should build on this momentum, encouraging and empowering places to develop strategies to meet housing need across local authority boundaries, drawing on lessons from the last Labour government's Total Place initiative, which showed early signs of success in its first year of operation.

Since 2012, affordable housing delivery in London has benefited significantly from the devolution of housing funds and policy to the Mayor of London through 5-year settlements with central government. Eleven years on, it is time for other cities and other places to gain more control over the levers for delivering new homes. Some combined authorities and unitary authorities are ready now to benefit from longer-term funding settlements with central government, as London does, while others should be supported to move in this direction. As in London, the devolution of housing funds should be supported by direct funding for skills training to support locally-led housing delivery and by additional powers to collect and redeploy Right to Buy sales receipts at the Combined Authority level.

Recommendation 17: the next government should continue and accelerate the welcome change in grant funding rules towards greater devolution and area-based criteria, rather than national financial metrics.

4. Conclusion

The UK has suffered from an under-investment bias for decades, which is now widely seen as undermining both overall economic performance and the strength of the public finances. Headline rates of tax, borrowing and spending understandably dominate political debates about public investment. But separate from these high profile issues there are serious questions about the political and technical processes that govern the actual flow of money. The overall picture can best be described as over-centralisation, which in turn gives rise to both excessive, overcomplicated controls imposed by the centre on the rest of the system, and to frequent, erratic changes in these controls driven by political and institutional incentives on actors at the centre, not the long-term needs of the country. These long standing tendencies of the UK system have been entrenched in recent years first by austerity-driven reductions in public investment in general, and local government budgets in particular, and then by erratic changes in central government policy in the face of successive crises.

Some of the drivers of this culture of centralised control stem from national governments' own choice of fiscal targets and the measures used to express them. While fiscal rules undoubtedly have a value, these choices should not be allowed to create perverse incentives like the pronounced under-investment bias that has marked UK policy-making for decades. At the very least fiscal targets should recognise the difference between borrowing to invest and borrowing to cover current expenditure: they should also treat types of investment that generate their own income streams differently from those that do not. The most straightforward way to do that would be to use the international standard General Government Gross Debt measure for any debt target, which would exclude local authority borrowing under their Housing Revenue Accounts.

Central government's fear that removing the arbitrary caps and constraints on investment by sub-national government and agencies will result in excessive and irresponsible borrowing is unfounded – and in any case the current system has largely failed to limit overall borrowing levels. Fiscal probity can be better achieved through clear and transparent frameworks of governance and accountability – as demonstrated by the success of the Prudential Code – than through Whitehall micro-management of decisions and repeated arbitrary changes to the rules designed to meet short-term political objectives.

Maintaining a rational and stable fiscal, accounting and financial regime is essential to give all stakeholders the confidence they need to borrow, invest, develop and manage housing and infrastructure at greater scale, speed and quality

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